

# Economics & Strategy

## Red October

Sovereign risk ratios are deteriorating rapidly and taking their toll on foreign reserves, the exchange rate and financial market confidence. The fall out on the real goods sector and fiscal management is likely to be severe in FY09 with further deterioration of GDP and Tax Revenue growth. Policy makers seem to have had no luck with their fund raising missions while draconian measures including the KSE 100 freeze buy time for market participants. We feel this will exacerbate systemic risks and complicate exposure levels in the future.

### A friend in need...

Little has been achieved in the wake of the GoP's debt seeking activity; we are still not sure about the USD 6bn Saudi oil facility or the commitment of 'Friends of Pakistan' while the visiting IMF analysts took to their heels soon after the security slippages in the capital city Islamabad. Meanwhile distress signals are evident in the rapid pace of debt payments in 2mo FY09 versus debt inflows into the Financial Account during the corresponding period last year.

### Liquidity constraints distorting market rates

In our Sep08 Economics & Strategy we had highlighted the fact that liquidity concerns would supersede inflation risks; in Oct08 O/N Call Monday rates soared past a staggering 40% however on average remain in the range of 18% in Oct08 compared to 12% a month earlier. Even though headline CPI inflation has roared to 25% in FY09 monetary authorities may be compelled to ease policy as domestic liquidity contracts. Although a contrary move to the recent monetary tightening, it may be necessitated by the debilitating balance of payments outflows averaging USD 1.25bn a month, threat of capital flight and high government borrowing already at PKR 170bn. Although market rates could stabilize in the interim we expect the central bank to cut reserve requirements by 100bps to help the financial system cope.

### Security slippages exacerbating capital flight

The nuisance factor of militant activity in border areas with Afghanistan has permeated the urban infrastructure and poses a serious threat to the political framework. The violent fallout of the US's War on Terror, evident in the chaos of the Islamabad Marriot Hotel bombing, is likely to persist with future security slippages which will erode confidence in financial markets and government policies.

### KSE 100 P/E target downgraded toward 5-6x earnings

With vulnerability ratios in dangerous territory we are downgrading our forward P/E expectations for the KSE 100, currently frozen at 8x trailing earnings. Risk ratios are similar to distress levels of the late 1990s and will likely drag market prices towards the 5-6x earnings. We advise investors to maintain a cautious approach to the KSE; opportunities below the 7,000 mark on the KSE 100 index indicate room for gains on our top picks which include PPL, KAPCO, LUCK, HBL and BAFL. However prices are likely to remain encumbered by both domestic and foreign liquidity, political, regulatory risks and weak economic fundamentals.

### Negative impact on real goods sector and fiscal management

The real goods sector and fiscal management are unlikely to escape the rising exchange, interest rate and commodity price risk. We expect GDP growth to slow towards the 3% range in FY09 while tax revenue targets will be hard to meet, leaving the burdens of subsidies and debt servicing to be balanced with increased foreign assistance.

### Zainab Jabbar

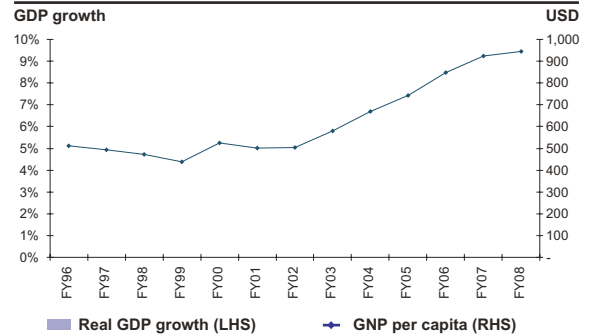
[zainab.jabbar@igi.com.pk](mailto:zainab.jabbar@igi.com.pk)

111-234-234 Ext. 810

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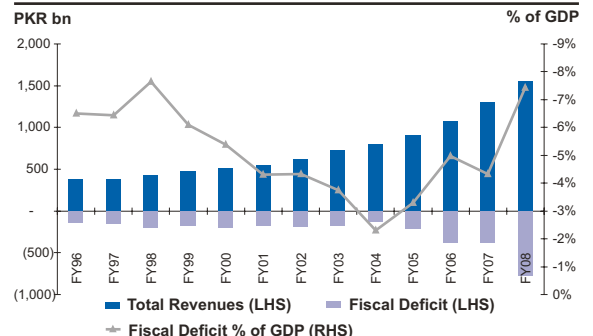
Data as of October 07, 2008

**Chart 1: GDP growth and Per Capita Income**



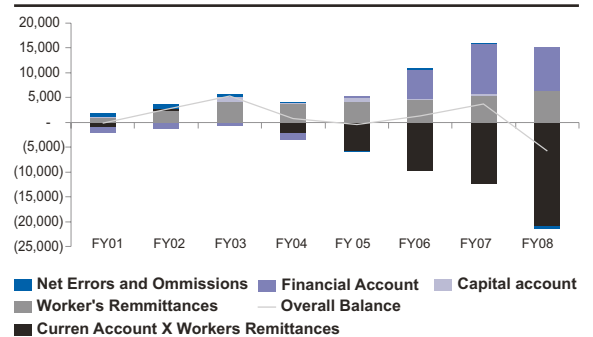
Source: Economic Survey, IGI Research

**Chart 2: Fiscal Management**



Source: Economic Survey, IGI Research

**Chart 3: Balance of Payments (USD mn)**



Source: SBP & IGI Research



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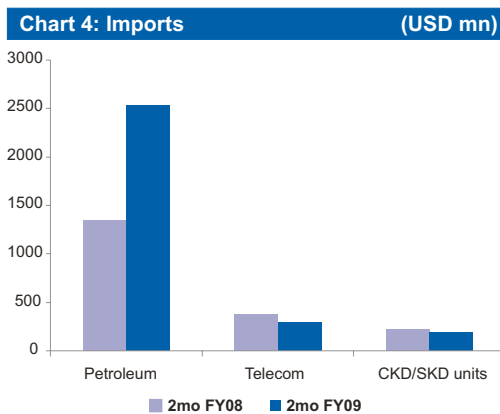
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### Capital flight

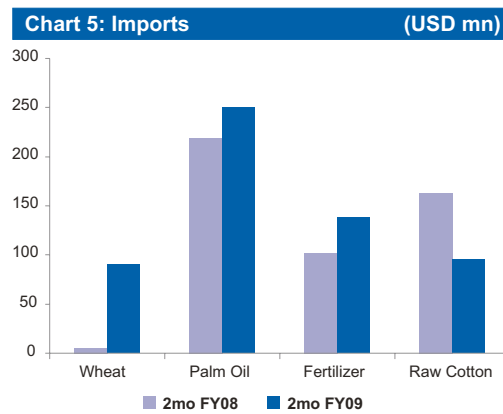
The key economic themes of the past month have been the continued slide of the PKR and depletion of foreign reserves. Policy makers seem to be achieving little towards the end of arresting this slippage. The Finance Ministry has highlighted potential for strategic sales of public assets, temporary assistance from allies including Saudi Arabia and China and accelerated external borrowing activity however no confirmation of capital inflows from these channels has been received.

### Export growth to remain laggard

The GoP target of 16% export growth to the USD 22bn level is likely to be achieved given the 30% depreciation of the PKR over Jun07 levels. However with respect to Value Added Manufacturing Pakistan still remains at the lower end of the spectrum amongst developing country peers. Given the narrow export base, dominated by textile manufactures at more than 60% of total exports, Pakistan's trade balance is unlikely to show much improvement from the USD 21bn (FBS) deficit incurred in FY08.



Source: FBS



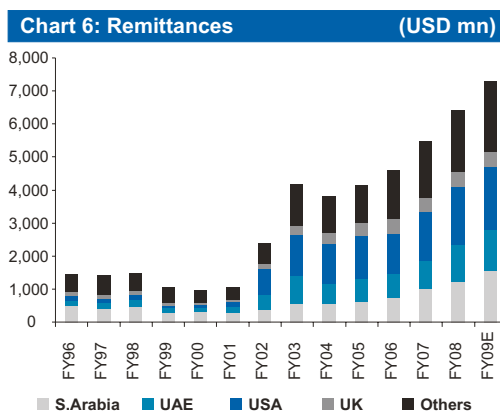
Source: FBS

### Food and oil will continue to drive import growth

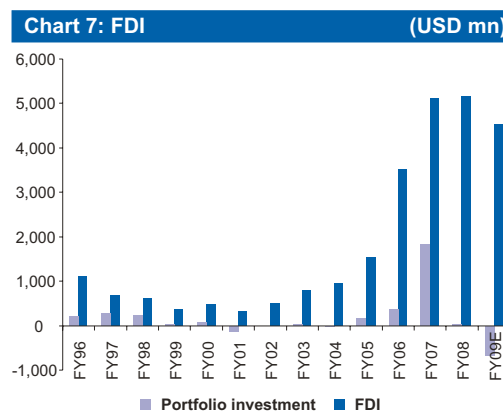
We expect food and oil to dominate the import bill in FY09; in 2mo FY09 Petroleum products imports have constituted 36% and 7% of the USD 7bn import basket respectively and shown a value increase of 14% and 88% respectively. Machinery and Agriculture imports have given up import value share to the former 2 import segments however remain largely stable at 17% and 16% of total imports. We expect food and commodity imports to remain elevated as supply side constraints continue to hinder domestic price stability. Key items include wheat and cotton which could face a downward revision in output as water, power and costlier fertilizer imports hinder yields. In addition the average cost of crude oil imported rose by nearly 91% to USD 123/bbl in 2mo FY09 compared to the same period last year. Moving forward we expect crude oil imports to average close to USD 110/bbl in FY09 while the overall petroleum products bill is likely to hover around USD 13.6bn in line with Planning Commission targets.

### FDI and Remittances likely to dwindle in 2H FY09

The government's FDI and Remittances target was close to USD 6.6 and USD 7.7bn for FY09. We had initially expected both categories to lend support to the balance of payments however we have revised our expectations of Private Investment Receipts downward on account of the serious policy gaps, political instability and resultant credit rating cuts which the economy has had to face. Remittances are also likely to suffer in 2H FY09 on account of further currency depreciation and the global economic slowdown. Consequently expectations of USD 14bn in investment and remittance inflows are unlikely to materialize are remain closer to the USD 10bn mark.



Source: SBP



Source: SBP

#### **Debt needs closer to USD 10-12bn**

Against a target of approximately USD 6.6bn for FY09 in Gross Disbursements, Official Assistance and Debt Relief the GoP has received only a trickle of flows in the first 2mo of the fiscal period. A net outflow of USD 613mn was witnessed in the Other Liabilities segment which includes both Long term and Short term loans, compared to a net inflow of USD 808mn in the same period last year. Given the significant value of foreign debt servicing including the Feb09 Eurobond, rapidly depreciating PKR, hefty import payments and USD 2.5bn in portfolio investment liabilities it is imperative that the GoP consolidate efforts to boost its foreign reserve position.

Based on the MoF foreign assistance target of PKR 300.4bn for FY09 at the Jun08 PKR exchange rate of PKR 68, the GoP was probably expecting between USD 4-5bn in external assistance. Against our estimates of an Jun09 exchange rate of PKR 91 to the USD, this number falls dramatically to USD 3.3bn. This is significantly lower than GoP expectations also reflected in the Planning Commission's Balance of Payment's target of USD 6.6bn.

The GoP will have to double its external assistance target closer to the USD 10-12bn mark in order to maintain relative stability of the external accounts position and stem the exchange rate slide. This is likely to be a challenge in light of the global economic slowdown, financial distress in developed economies and limited external liquidity as cross border flows dry up. The estimated USD 1bn each from the IDA and ABD are unlikely to arrest the balance of payments deterioration which could have a severe impact on domestic liquidity.

#### **Geo-political argument weakens**

Pakistan's geo-political significance is only as strong as its policy makers; if multi-lateral donors and 'Friends of Pakistan' do not feel the political framework can manage the economy and the slipping security situation on its borders, the validity of this argument is likely to fade.

We feel the GoP should be able to secure global support in view of Pakistan's proximity to the situation in Afghanistan and involvement in the US's War on Terror. However constrained global liquidity and limited cross-border flows are likely to limit funding and tighten terms and conditions. In light of the recent global financial distress funds could also face delays which may put Pakistan in a difficult spot till macro headwinds ease up in developed countries.

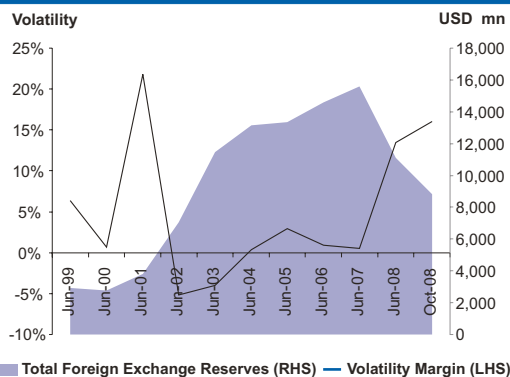
#### **Rating cut to heighten capital flight risk**

Standard & Poor's Ratings Agency has lowered Pakistan's long-term foreign currency rating to CCC+ from B with a negative outlook. Moreover, the rating on its long-term local currency has been downgraded to 'B-' from 'BB-', while the short term rating on sovereign was cut to 'C' from 'B'. As per agency definitions, a CCC rating is applicable where an obligation is considered currently vulnerable to nonpayment, and is highly dependant on favorable economic, business and financial conditions to meet its commitment on obligations. Pakistan's currency was last rated CCC in 1998 after the country tested its nuclear devices in response to India's nuclear tests.

#### **Likelihood of sovereign debt default increasing**

The rating cut comes on account of rising concerns about Pakistan's ability to meet its upcoming sovereign debt payments amounting to USD 3bn, as total FX reserves declined to USD 8.1bn during the week ended Sep 27'08 against the peak of USD 16.47bn in Oct07, leaving the country with less than 7 weeks of import cover. Burgeoning oil payments have dragged the trade deficit to USD 3.52bn in 2mo FY08 against USD 2.38bn in the corresponding period last year, while the Current Account Deficit (CAD) has reached USD 2.57bn depicting an increase of 64% over the same period last year. The PKR has also depreciated by more than 30% against the USD to reach PKR 79.60 on Oct 8'08 against Oct07 levels of PKR 61.

**Chart 8: Foreign Reserves and Exchange Rate**



Source: SBP, IGI Research

**Vulnerability ratios poorest among category B peers**

The rating cut does not come as a surprise, as FY08 witnessed a dramatic deterioration in Pakistan's vulnerability ratios as compared to its B rated peers including Indonesia and Philippines. Even during the economic boom in the country during 2006, Pakistan still depicted a comparatively weak position compared to peers; Pakistan's Current Account Balance to GDP ratio stood at -6%, while the group average was at 6%. Prior to the rating cut of Oct 6'08 the situation was clearly much worse. Pakistan's category C peers now include Lebanon.

**Table 1: Sovereign Risk Indicators**

	Pakistan	Philippines	Indonesia
CAD % of GDP	(9.0)	4.4	2.6
Total Debt % of GDP	66.0	53.0	39.0
Total Revenues % GDP	14.0	16.0	22.0
FDI % of GDP	3.3	1.0	0.3
Trade Balance % of GDP	(21.0)	(5.7)	7.7
EDLs % GDP	66.0	38.0	32.9
Debt servicing % GDP	4.0	5.1	37.5
Fiscal Deficit % GDP	(7.5)	(3.1)	(2.1)
EDLs USD bn	48.4	55.0	142.0
FX Reserves USD bn	10.0	36.2	59.5
BoP USD bn	(6.5)	8.6	8.5

Source: Source: Bloomberg, S&P, Central Bank of Philippines, SBP, Central Bank of Indonesia

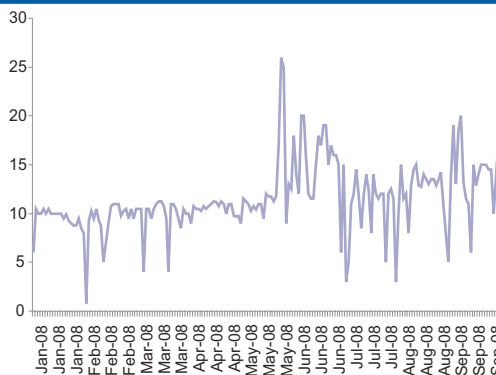
### Money markets feel the pinch

#### Market rates soar on liquidity constraints

A liquidity crunch pushed O/N Call Money rates close to 40% over the Eid holiday week as banks struggled to meet reserve requirements and liquidity demands. O/N Call rates in Sep08 remained in the range of 12% very close to the DR of 13% but bounced up towards the 40% level on Oct 4'08. By Oct 7'08 rates appear to have relaxed close to the 13% level again however the SBP had injected a substantial amount of liquidity via OMOs in the past month.

Chart 9: ON Call Money Rates

(%)



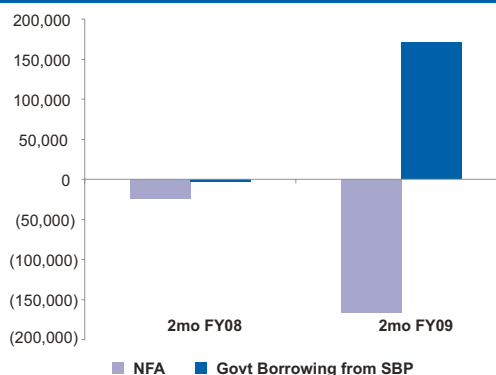
Source: Bloomberg

#### NFA outflow and government borrowing eroding PKR liquidity

NFA outflows have reached PKR 166.5bn on Sep 20'08 against just 24bn last year. Government borrowing from SBP was also up to PKR 170bn in the 1Q FY08 diminishing the possibility of the GoP retiring PKR 24bn of its direct debt every quarter as requested by the SBP. With the increasing pace of depreciation and the PKR crossing the 78.50 mark by early Oct08 PKR liquidity is also thinning as more of the domestic currency is required to fund capital outflows. Excess government borrowing will ultimately crowd out private sector credit and choke liquidity which will reduce refinancing capacity and increase risk of default.

Chart 10: NFA and Government Borrowing

(PKR mn)



Source: SBP

#### Trimming reserve ratios could be an option

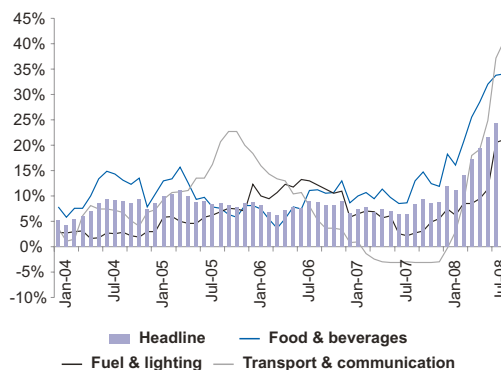
Currently the Cash Reserve Ratio (CRR) stands at 9% and we believe the liquidity crunch could trigger a 100bps cut in the rate. Key distress signals supporting a CRR cut are the O/N Call Money rate hitting 40% on Oct 4'08, 25% inflation cutting into disposable incomes, the large Balance of Payments outflows averaging at USD 1.25bn a month and the increased OMO injections by the SBP.

In Sep08 and the first week of Oct08, OMO activity injected PKR 230bn into the system versus just PKR 27bn in liquidity mopped up. The need for this injection was amplified by the seasonal cash requirements around the Eid holidays and has subsided in the post holiday period however O/N Call Money rates remain at an average 18% versus 12% Sep08. Liquidity is tight and with external flows drying up, government borrowing needs on the rise and foreign reserves depleting rapidly, the capacity of the central bank to manage domestic interbank flows may also diminish.

**Sep08 CPI inflation to remain in 25% range**

As expected Aug08 inflation was close to 26% driven by Food & Beverage, Fuel & Lighting and Transport & Communication inflation of between 25-43% respectively. CPI inflation has accelerated to a 30-year high to reach 25.3% YoY while Food inflation was the rose by 34% over the same period last year. Fuel & Lighting and Transport & Communication also reflected increasing pressure, rising by 21% and 41% respectively.

**Chart 11: Headline CPI Inflation Key Components**



Source: FBS

Sensitive Price Indicator data for Sep 30'08 reflects a similar trend for the next month; Petrol and Diesel (HSD) prices are up by 53% and 81% respectively over the corresponding week last year. This is coupled with an increased in LPG prices by 50%, Kerosene by 89% and Electricity by 16% compared to the same period last year. SPI inflation for 53 essential items showed an increase of 30% over the same period last year for combined income groups with the heaviest burden of 31% falling on the lowest income group.

Despite a strikingly negative real rate of return and dire need for inflation monitoring we feel the central bank will be compelled to preserve manageable liquidity levels rather than manage inflation risk. The likelihood of another rate hike is minimal as NFA outflows and the depreciating currency batter the financial system. If the SBP were to raise the base rate now, the trade-off appears to be too dear in the current scenario. The marginal slide in inflation and strengthening of the currency would be short lived compared to the deep distress caused from liquidity contraction across the system.

## KSE: Where's the bottom?

### Crumbling Credibility

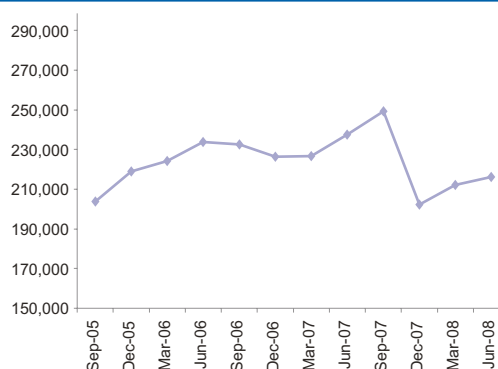
On Sep 9'08 KSE members unanimously demanded the Board of Directors maintain the floor on share prices of Aug 27'08 closing level for indefinite period. The market freeze remains in place a month later signaling that RMS (risk management systems) have failed and brokers will be buying time to meet their margin calls, financial obligations and consolidate their positions. We feel this has damaged KSE credibility in the short run; but is not irrevocable in the medium term. Regulators will have to let market forces prevail and minimize systemic weaknesses before both foreign and domestic investor confidence returns to Pakistan.

### Trailing Earnings down; Price to follow

According to our estimates KSE 100 Last Twelve Months (LTM) earnings have been on the decline since Dec07 over the corresponding period last year and will depict a 9% decline in Jun08. A Weighted Average KSE 100 Market Analysis suggests the market was frozen at 8x trailing earnings for Jun08. At current prices we believe the market still represents a downside and caution investors to dig deeper for attractive valuations.

Chart 12: KSE 100 LTM Earnings

(PKR mn)



Source: IGI Research

### Historical trend lines suggest market could dip to 5-6x earnings

According to our estimates Pakistan's vulnerability ratios deteriorated to reflect a distressing similarity to the late 1990's. The increasing sovereign risk signaled an inevitable downgrade from the economy's earlier developing country 'B+' peer group of Philippines and Indonesia to the 'CCC+' peer group constituting Lebanon and Seychelles.

In 2007 Pakistan ranked amongst top 20 Emerging Markets in S&P ratings in terms of GDP per capita, Current Account to GDP, Fiscal Deficit to GDP, Debt to GDP and Gross External Financing Needs to Reserves and Current Account Receipts. The situation has changed dramatically in 2008 with Pakistan dropping off this particular Emerging Market map.

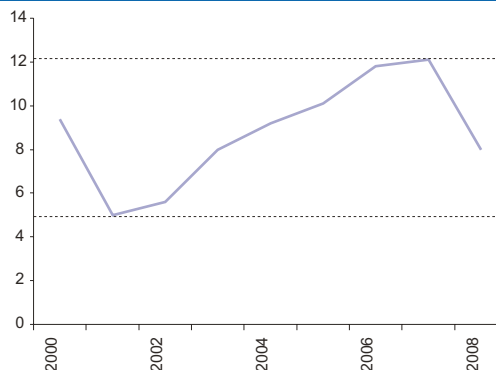
Table 2: Pakistan Sovereign Risk Ratios

	2007	2008
Fiscal Deficit/GDP	4.3	7.4
Net Debt/GDP	57	64
Current Account Deficit/GDP	4.9	9
Net FDI/GDP	5.5	4
EDLs/FX Reserves	2.6	5.5

Source: S&P & IGI Research

Given the increasing risk premium we feel the KSE 100 P/E multiple could dip towards the 5-6x mark or lower. If multi-lateral donors, domestic investors and the Pakistani diaspora begin to lose confidence in the political infrastructure this could result in diminishing remittance and debt flows. Refinancing difficulties could destabilize the exchange rate further and lead to severe economic stress which will take its toll on the financial markets.

Chart 13: Historic KSE 100 PE

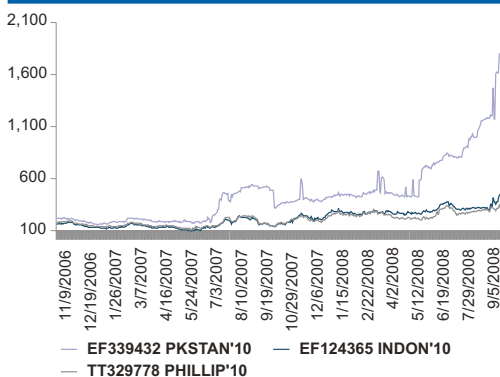


Source: IGI Research

**Eurobond and CDS spreads reflect lack of confidence**

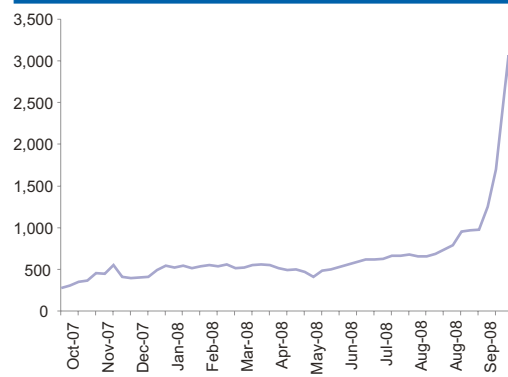
Sovereign risk indicators are sharply reflected in the 5yr credit default swap spreads (CDS) which continue to show stress. As of Oct08 the spreads on 5yr CDS, used to ensure against restructuring or default of sovereign debt, widened to a massive 2050bps reflecting deepening political crisis and economic instability. There has also been an unprecedented spike in spreads of the Pakistan Eurobond 2016 launched at 370bps over the benchmark US Treasury notes. The spread has widened by nearly 1200bps since Apr08 to reach 1800bps against the relevant UST and a staggering yield of 21.5% reflecting deteriorating debt servicing capability.

Chart 14: Eurobond spreads (bps)



Source: Bloomberg

Chart 15: CDS spreads (bps)



Source: Bloomberg

**Regulatory risk extends to Equity based Mutual Funds**

In a circular dated Oct 07'08, the SECP has decided to suspend issuance and redemptions of units of open-end equity based funds until the third day after the floor mechanism from the stock exchanges is removed. The decision comes in response to a request by the Mutual Fund Association of Pakistan (MUFAP) to the regulator to freeze issuance and redemptions from equity based funds. This will allow mutual funds to liquidate their positions in the first three days of market movement, consolidate their positions and prepare themselves for the redemptions from panicky investors they are likely to face on the 4th day of market trading, whenever it may be.

**KSE BoD groping in the dark**

The KSE BoD has repeatedly intervened in the stock market with the support of the broking community. On Jun 24'08 the board established a temporary 1% lower lock and 10% upper lock on stock prices. Lower and upper circuits were later removed in the 2nd week of Jul08 to revert to the original 5% upper and lower limits. Following this PKR 20bn was injected into the market by NIT and a couple of days after the funds propped up the market, the KSE 100 again dipped into the red.

The KSE BoD then proceeded to freeze the market indefinitely. Prodded by ruffled foreign investors, the SECP and Ministries of Finance the lower locks may be removed in the upcoming weeks however are likely to be followed with further intervention. We feel this is an extremely challenging strategy; on the one hand it allows market players time to consolidate positions and on the other hand it exacerbates systemic risks. The complication of exposure levels may reach unmanageable levels and if the KSE BoD is unable to intervene this may create severe financial distress across capital markets.

## Research Team

Zainab Jabbar	Investment Strategy, Economy	Tel: (92-21) 111-234-234 Ext.:810	zainab.jabbar@igi.com.pk
Ashar Khaliq	E&P, Automobile, Power Generation	Tel: (92-21) 111-234-234 Ext.:811	ashar.khaliq@igi.com.pk
Sarah Junejo	Refinery, Cement	Tel: (92-21) 111-234-234 Ext.:823	sarah.junejo@igi.com.pk
Ahmed Raza Khan	Consumer, Oil & Gas Marketing, Banks	Tel: (92-21) 111-234-234 Ext.: 804	ahmed.raza@igi.com.pk
Abdul Sajid	Database	Tel: (92-21) 111-234-234 Ext.:813	abdul.sajid@igi.com.pk
Mansoor Ahmed	Design, Layout	Tel: (92-21) 111-234-234 Ext.:812	mansoor.ahmed@igi.com.pk

## Equity Sales

Azhar Ahmed Batla	Tel: (92-21) 530-1713	azhar.batla@igi.com.pk
Sher Afgan (LHR)	Tel: (92-42) 630-0082	sher.afgan@igi.com.pk
Shafqat Ali Shah (ISL)	Tel: (92-51) 280-2243	shafqat.ali@igi.com.pk
Chaudhry Usman Javed (SKT)	Tel: (92-52) 3242689	usman.javed@igi.com.pk
Muhammad Ejaz Rana (FSD)	Tel: (92-41) 254-0854	ejaz.rana@igi.com.pk



# IGI

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# Securities

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## Head Office

7th floor, The Forum, Suite 701-713, Khayaban-e-Jami, Clifton, Karachi  
Phone: (92-21) 111-234-234 Fax: (92-21) 111-567-567, 5301729

## Branch Offices

### Karachi (Clifton)

F-5, Block 9, Clifton, Karachi.  
Phone: (+92-21) 5309258-60 Fax: (+92-21) 5309168

### Karachi - KSE

Room # 70, 1st Floor, KSE Bldg. Karachi Stock Exchange Road, Karachi  
Phone: (92-21) 2429601-06 Fax: (92-21) 2429607

### Lahore

5-F.C.C. Ground Floor, Syed Maratib Ali Road, Gulberg, Lahore  
Phone: (92-42) 5756701, 5777861-70 Fax: (92-42) 5762790

### Lahore - DHA

75-T, Phase 2, DHA (near Lalak chowk), Lahore  
Phone: (92-42) 5707411-33 Fax: (92-42) 5748935

### Islamabad

Mezzanine Floor, Razia Sharif Plaza, 90 – Blue Area, G-7, Islamabad  
Phone: (92-51) 111-234-234, 2802241-43 Fax: (92-51) 2802244

### Faisalabad

9th Floor, State Life Building, 2 – Liaqat Road, Faisalabad  
Phone: (92-41) 2540843-45 Fax: (92-41) 2540815

### Sialkot Office

Room No: 206, Sialkot Trading floor, Cantt Plaza, Sialkot Cantt.  
Phone: 052 -4566032-36 Dir.: 052 – 4566034-36 Fax: 052- 4566035

### Multan Office

C-2, 1st floor, Hassan Arcade, Multan Cantt.  
Phone: (92-61) 4784401-02 Fax: (92-61) 4784403

### Gujranwala Office

Nasir Plaza, Main GT Road, (Adjacent to New Railway Station), Gujranwala  
Phone: (92-55) 3841346-48 Fax: (92-55) 3257453

### Peshawar Office

Mall Tower, 2nd floor, 35. The Mall Peshawar  
Phone: (92-91) 5253980-88 Fax: (92-91) 5253989

